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A web bubble blown out of proportion

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By Thomas Hazlett

The economist Paul Samuelson likes to joke that Wall Street indices predicted nine out of the last five recessions. So too in the new economy, where the fruits of success are often hailed as harbingers of doom.

Squeals of irrational exuberance could be heard only moments after the dotcom bust hit bottom. Google's initial public offering in August 2004, the first truly bullish news in years, splashed "Bubble 2.0" headlines across the media. Dire warnings again bubbled up in September 2005, with Ebay's $2.6bnpurchase of Skype, the internet telephony service. Now, seeing Silicon Valley types "party like it's 1999" on the strength of social networking start-ups, even respectable business magazines feature stories grimly warning investors not to believe the hype.

Keeping one's head is pretty sound advice in any context. The Nasdaq skydive falling 78 per cent from March 2000 to October 2002 was very painful for those whose parachutes failed to open. The message is to diversify.

But the "Son of Bubble" horror plot does not live up to the original. In Bubble 1.0, the Nasdaq Index averaged more than 40 per cent annual returns from 1995-99. In other words, funds invested on January 1 1995 grew 437 per cent as of December 31 1999. In contrast, Nasdaq is today only about where it stood at year-end 1998, meaning that industry returns over the past eight years are close to zero.

Moreover, the price/earnings ratios of technology industry leaders yes, now they actually have P/Es are fairly standard. Microsoft and Cisco shares trade for prices about 16 times projected 2007 earnings, while Google's blow-out success yields a P/E ratio of 31. In 1999, the average P/E ratio for issues in the Standard & Poor's 500 wafted in the 32 to 37 range. Now, the S&P 500 average is down to 18. Compared with the actual bubble, equity markets are having a half-price sale.

Kevin Maney, writing in USA Today, described the sense of deja vu in living colour. "The tech industry is frothing," he wrote. "It is spewing companies and web doohickeys and blog amalgamisers and internet contraptions like video social-networking wiki cooking sites...Not even educated tech veterans can keep track anymore...[It's] hard to imagine how the world can absorb everything being pumped out there."

First, it won't. Second, the future is reticent about revealing which ideas it prefers. Venture capitalists spread their money far and wide, hoping the big hit or two pays for scores of flops.

Third, great innovations do not step into our world daintily or well-labelled. As noted, not even the tekkies can keep track.

The rush to embrace new web businesses may look like a knee-jerk response to, say, News Corp's $580m grab of MySpace.com. But those reflexes are embedded in the DNA of the capitalist internet. The scent of profit trips instincts. Packs of investors are soon hunting for the next big kill.

This primal urge co-ordinates enormous complexity. In pursuit of mutual advantage, investors and innovators mesh their interests by negotiating profit-sharing contracts. The buzz about web culture is that it promotes new and socially useful forms of sharing. These observations are correct in the sense that corporations organise common shareholders to pool their assets and bond with labour and management.

But they also play down the motivation behind the emergent culture: profit-seeking. Never was a social system so comfortable with science, technology and change. Nowhere else have people so naturally co-operated in seizing the opportunities presented by human ingenuity. Sampling alternative business models, services and products, the capitalist continuously calculates prospects for making markets anew. This system works by trial and error and amid the confusion some competitors will find remarkable success.

Take the wiki craze. Spurred on by the popularity of Wikipedia, the online encyclopedia that relies on written contributions from volunteers, the sprint is on. Collaborative sites are all the rage among start-ups and established corporations, which use them to improve internal communications. John Gotts, a Washington-based entrepreneur, has purchased "wiki.com" to provide a platform for what he hopes will be thousands of offerings. The founder of Wikipedia, meanwhile, is launching Wikia, a for-profit company that already hosts 1,500 wikis.

What is next? That wiki entry has not yet been written. Ramit Sethi, whose wiki helps do-it-yourself wiki builders, told the New York Times: "Nobody has found the de facto business model for wikis. It's kind of like the Wild West."

The cowboys racing on to this frontier aim to capture financial rewards and are inevitably dependent upon them for sustenance. In spite of the culture of sharing, venture capitalists determine who saddles up, and profits decide who wins. It is a fact that there will be far more riders than winners. That is not a bubble. That is creative destruction.

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